

BEFORE THE
ILLINOIS COMMERCE COMMISSION

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ILLINOIS BELL TELEPHONE COMPANY

Filing to Increase Unbundled Loop and
Nonrecurring Rates

ILLINOIS COMMERCE COMMISSION
Docket No. 02-0804
CHIEF CLERK'S OFFICE

DIRECT TESTIMONY

of

HARRY GILDEA

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE AND
ALL OTHER FEDERAL EXECUTIVE AGENCIES

PUBLIC VERSION

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(Proprietary Material indicated by ****)

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1 A. Yes. My work has been primarily in the telecommunications field, but I
2 also have participated in gas, electric and water cases, as well as cases concerning the
3 U.S. Postal Service. In my 30 years of experience in the telecommunications industry, I
4 have performed research and analyses concerning nearly all telecommunications
5 services, including local exchange, interexchange, access, Centrex, video, data,
6 wireless and other services.

7 Q. Have you previously participated in proceedings before this Commission?

8 A. Yes. I have testified in numerous proceedings before the Illinois
9 Commerce Commission. Most recently, I presented testimony in Docket No. 98-0252
10 *et al.* concerning charges by Illinois Bell Telephone Company ("SBC Illinois" or "the
11 company") for retail services to end users and interexchange carriers.

12 Q. Have you testified before other regulatory commissions?

13 A. Yes. I have testified as an expert witness before the Federal
14 Communications Commission ("FCC") and the Federal Energy Regulatory Commission,
15 in addition to the regulatory agencies of California, Colorado, Connecticut, the District of
16 Columbia, Florida, Georgia, Kentucky, Maryland, Massachusetts, Michigan, Missouri,
17 New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South
18 Carolina, Tennessee, Texas, and Virginia. Besides testimony, I have prepared and
19 presented written comments on telecommunications matters to the FCC and many state
20 regulatory agencies.

21 Q. Do you have additional experience in the telecommunications field?

22 A. Yes. I have served as a consultant to federal agencies on rate design and
23 tariff issues in numerous major procurements by the federal government, including
24 Aggregated System Procurements for local telephone services in 30 states, the
25 FTS2000 and FTS2001 systems for intercity telecommunications, the Metropolitan Area
26 Acquisition Program for services to federal offices in about 20 large metropolitan areas
27 throughout the nation, and the Washington Interagency Telecommunications System for

1 services to agencies in the Washington, D.C. area. Also, I have been a consultant to
2 the Defense Information Systems Agency concerning domestic and international rate
3 structures and services, and the costs of data and voice communications systems.

4 In addition, I have performed damage studies in three antitrust cases
5 involving telecommunications firms. Over the years, I have been engaged as a
6 consultant to telecommunications firms in several proceedings before the FCC, and a
7 case before the United States Court of Appeals. In addition, I have been a consultant to
8 the government of Canada, as well as carriers and end users of telecommunications
9 services in many regulatory proceedings. Also, I testified as an expert witness in a
10 proceeding before the General Services Administration Board of Contract Appeals
11 concerning the award of a major contract for telecommunications services.

12 Q. For whom are you testifying in this case?

13 A. I am testifying on behalf of the customer interests of the United States
14 Department of Defense and All Other Federal Executive Agencies ("FEAs").

15 Q. What is the subject of your testimony?

16 A. I address testimony and studies submitted by SBC Illinois concerning the
17 costs and charges for unbundled network elements ("UNEs").

18 **II. Interests of the FEAs**

19 Q. What are the customer interests of the FEAs in this matter?

20 A. The federal government is one of largest end users of telecommunications
21 services in Illinois because of the presence of many offices and military installations
22 throughout the state. As one measure of the extent of the FEAs' telecommunications
23 requirements, there were more than 93,000 federal civilian employees in Illinois in
24 December 2000.¹ In fact, Illinois exceeded all but seven states and the District of

¹ United States Office of Personnel Management, *Federal Civilian Workforce Statistics, Employment and Trends*, June 2002, p. 75.

1 Columbia in federal civilian employment at that time.² In addition, the Department of
2 Defense ("DoD") has a substantial presence because the state is home to Naval Station
3 Great Lakes, Scott Air Force Base, and other installations.

4 Q. Will the FEAs have access to UNEs?

5 A. As end users, the FEAs will not have direct access to the UNEs provided
6 by SBC Illinois. However, the prices, terms and conditions for UNEs that SBC Illinois
7 provides other carriers will determine whether there will be abundant and vigorous
8 competition for telecommunications services. The FEAs want more and stronger
9 competition to ensure that all end users can obtain the best telecommunications
10 services at the lowest possible costs.

11 Q. Is more competition especially important for users such as federal
12 agencies that employ formal acquisition procedures to acquire telecommunications
13 services?

14 A. Yes. To obtain the best available services at the lowest possible costs,
15 FEAs obtain services through competitive bidding procedures whenever possible.
16 Certainly, competitive bidding is more effective if there are more potential suppliers.
17 However, if competitive local exchange carriers ("LECs") cannot obtain the UNEs they
18 need at reasonable prices, there will be few alternative sources of supply available to
19 the government or other large end users seeking bids for telecommunications services.
20 Of course, vigorous competition benefits smaller end users as well.

21 **III. Competition**

22 Q. What is the company's view of competition in Illinois?

23 A. SBC Illinois witness Eric Panfil asserts that the company faces very
24 significant competition for telecommunications services.³ For example, he cites data in

² *Id.*

³ Direct Testimony of Eric Panfil, pp. 21-24.

1 an "Annual Report on Telecommunications Markets in Illinois" indicating that competitive
2 LECs served 12.2 percent of residence customers and 20.3 percent of business
3 customers in the state at the end of 2001.⁴ Moreover, he asserts that these figures
4 understate the extent of competition because of recent increases in competitors' lines.
5 Indeed, according to witness Panfil, competitors were serving 20 percent of residence
6 customers and 33 percent of business customers as of September 30, 2002.⁵

7 Q. Does witness Panfil also cite a report by the Federal Communications
8 Commission ("FCC") on competition?

9 A. Yes. He refers to the most recent FCC report on local competition, which
10 states that competitive LECs were serving 14 percent of residence and small business
11 customer lines and 22 percent of large business customer lines in Illinois as of June 30,
12 2002.⁶ He contends that the line counts in the FCC report also understate current
13 competition because they are for an earlier period and also do not include data for
14 competitive LECs whose activities are below the reporting threshold.⁷

15 Q. What is your assessment of witness Panfil's claims?

16 A. It is important to view his claims in context. In the first place, I do not
17 regard competitive LECs whose activities are below the reporting threshold as a serious
18 competitive threat to SBC Illinois. The parent company, SBC Communications Inc.
19 ("SBC") reported to its stockholders that it has "evolved into one of the world's largest
20 and technologically advanced telecommunications companies."⁸ The organization has
21 substantial revenues from local and long distance services, and is the "nation's leading
22 provider" of digital subscriber line ("DSL") services.⁹

⁴ *Id.*, p. 22.

⁵ *Id.*, p. 21.

⁶ *Id.*, p. 22.

⁷ *Id.*

⁸ SBC Annual Report 2002, p. 2.

⁹ *Id.*, pp. 2-3.

1 Q. Does SBC Illinois also face competition from other modes of electronic
2 communications?

3 A. Yes. Wireline services face substantial intermodal competition, for
4 example by mobile wireless services. Unquestionably, mobile wireless usage has
5 increased greatly. Indeed, it is likely that some users have abandoned wireline services
6 entirely in favor of mobile wireless and other options. However, this is not necessarily a
7 net loss for SBC. On a consolidated basis SBC obtained operating revenues of \$8.8
8 billion and operating income of \$1.5 billion from wireless services in 2002.¹⁰

9 Q. Does SBC Illinois face direct wireline competition from competitors serving
10 end users through their own facilities?

11 A. Yes, but it is important to note that figures on competitors' operations
12 include service provided using three modes of competition: (1) services provided
13 through UNEs, (2) resale of the incumbents' offerings, and (3) services provided over
14 the competitive LECs' own facilities. For two of these types of competition — UNEs
15 and resale — SBC Illinois owns most or all of the underlying facilities. Thus, much of
16 the "competition" actually provides SBC Illinois with income.

17 Q. Does an SBC Illinois report show this effect?

18 A. Yes. SBC Illinois provided a report on Local Competition in Illinois in
19 response to a data request by the Staff.¹¹ That report, covering the period through the
20 third calendar quarter of 2002, states "One conclusion jumps out when examining
21 competitive data on the Illinois market: CLECs are relying heavily on SBC's network to
22 increase their market share."¹² The report emphasizes that the majority of recent
23 competitive growth has been through the UNE platform ("UNE-P"), which is the

¹⁰ *Id.*, p. 12.

¹¹ "Corporate Competitive Analysis" provided by SBC Illinois in response to Staff Data Request No. PL 1.01b.

¹² *Id.*

1 combination of a loop and a switch.¹³ Thus, in most cases, SBC Illinois obtains revenue
2 for both loop and switch facilities. Indeed, it appears that SBC Illinois may be providing
3 about as many local loops as it would with no competitors at all.

4 Q. Why?

5 A. The company contends that it has lost, cumulatively, about 942,000 retail
6 access lines as of the third quarter of 2002.¹⁴ On the other hand, the company's
7 responses to data requests by AT&T Communications state that SBC Illinois provided
8 335,000 unbundled UNE loops without switching and 562,000 UNE-Ps as of September
9 2002.¹⁵ This is a total of 897,000 loops provided to competitors. The 897,000 lines
10 nearly counterbalances the retail "loss" of 942,000 lines, some of which would have
11 occurred in any event because of customer transitions to cable modem and wireless
12 technologies for access to the switched network.

13 Q. In sum, how should competition be gauged?

14 A. The most important consideration is the company's market power.
15 Assuming the accuracy of the "most recent" competitors' shares claimed by SBC Illinois
16 (competitors have 20 percent of residence lines and 33 percent of business lines) the
17 competitors' overall share would be on the order of 25 percent of all lines. Thus, SBC
18 Illinois has three times as many lines as all of its competitors combined. From this
19 perspective, SBC Illinois still enjoys enormous power in the retail market in Illinois.

20 Q. What is the state of competition in the wholesale market?

21 A. SBC Illinois is the only firm that can provide access to its ubiquitous
22 network. If competitors need UNEs in the company's operating area, they must obtain
23 them from SBC Illinois. Thus, I would say that SBC Illinois has a virtual monopoly in the
24 wholesale market in the area it serves as the incumbent LEC.

¹³ *Id.*

¹⁴ *Id.*, p. 4.

¹⁵ SBC Illinois Response to AT&T Data Request Nos. JG 4a and JB 4b.

1 Q. What is the consequence of these conditions?

2 A. It is important for the Commission to consider the market power that SBC
3 Illinois still enjoys as it makes decisions concerning the costs — and ultimately the
4 charges — for UNEs in Illinois. At least from the FEAs' perspective, I can say that end
5 users still depend upon regulatory authorities for actions that will foster healthy and
6 vibrant competition for telecommunications services.

7 **IV. Proposals by SBC Illinois**

8 Q. What are the company's proposals in this case?

9 A. SBC Illinois is proposing increases in the monthly charges for UNE loops,
10 including analog basic loops, as well as DS-1 and DS-3 loops.¹⁶ The proposed
11 charges are applicable to UNE loops provided on a stand-alone basis and or as part of
12 a UNE-P.¹⁷ Also, the company is proposing increases in its non-recurring charges for
13 stand-alone loops, UNE-Ps, enhanced extended links, and conversions of special
14 access services to existing UNE loop/dedicated transport combinations.¹⁸

15 Q. Are the proposed increases significant?

16 A. Yes. Although the scope of the filing is limited in terms of rate elements,
17 the company's proposals have a major impact because the proposed increases are
18 huge. For example, the present and proposed monthly charges for basic analog loops
19 used to provide voice services to business and residence customers are:¹⁹

	<u>Current Monthly Charge</u>	<u>Proposed Monthly Charge</u>	<u>Proposed Percentage Increase</u>
Access Area A	\$ 2.59	\$ 11.62	349 %

¹⁶ Direct Testimony of Michael D. Silver, pp. 2-3.

¹⁷ *Id.*, p. 3.

¹⁸ *Id.*

¹⁹ Direct Testimony of Eric Panfil, p. 14.

1	Access Area B	\$ 7.07	\$ 23.23	229 %
2	Access Area C	\$ 11.40	\$ 26.85	136 %

3 The charge for Access Area A, which includes densely developed places where many
4 business customers are located, will increase by a factor of nearly four and one-half.
5 Even for Access Area C, with the lowest subscriber density, the charge will more than
6 double.

7 Q. In your view, what is the significance in the fact that SBC Illinois has
8 focused its rate increase proposals on local loops, as opposed to switching elements or
9 vertical services?

10 A. The local loop is a "gateway" element. This facility may be a stand-alone
11 element, or used in conjunction with other elements such as switching in the UNE-P.
12 Most other network elements are seldom used on a stand-alone basis. Thus, SBC
13 Illinois has more "leverage" in pricing loop UNEs than other UNEs. Moreover, local
14 loops carry most of the costs. The costs and (cost-based) charges for many other
15 UNEs are typically in the range of a couple of dollars or less. Indeed, costs for some
16 switched-based vertical features are a few pennies a month. If SBC Illinois were to
17 "update" those costs (using the same methodologies as for loops in the instant case)
18 and propose corresponding increases in UNE charges, the company would obtain
19 relatively little additional revenue. As a mathematical proposition, more revenue is
20 obtained by tripling a loop charge of seven dollars than by tripling the charge for an
21 element priced at one dollar.

22 Q. How does SBC Illinois compute costs as support for its rate proposals?

23 A. SBC Illinois is not using the same models as in the previous UNE
24 proceeding.²⁰ The company contends that those approaches were superseded "by

²⁰ *Id.*, p. 15.

1 more up-to-date, Ameritech-generated, models and data samples.”²¹ Moreover,
2 following the merger with Ameritech in 1998, its models were updated for consistency
3 across the company’s overall operating area, to operate on personal computers instead
4 of mainframe computers, and “to better meet the needs of the regulatory process.”²²

5 Q. Has SBC Illinois identified specific differences in its models and costing
6 procedures between this case and the last UNE case?

7 A. Yes. Differences are listed in a schedule with the testimony of SBC
8 witness James R. Smallwood.²³ I shall discuss several of the differences in this
9 testimony.

10 Q. How does SBC Illinois characterize the cost models it employs in this
11 case?

12 A. The company contends that they produce forward-looking costs that are
13 consistent with the requirements established by the FCC for Total Element Long-Run
14 Incremental Costs (“TELRIC”) used to set the charges for UNEs.²⁴ According to SBC
15 Illinois witness Smallwood, the company’s studies employ forward-looking network
16 designs, forward-looking technologies, and forward-looking material costs.²⁵
17 Moreover, SBC Illinois witness Panfil asserts that the TELRIC methodology that SBC
18 Illinois employs for UNEs is “very similar” to the long run incremental cost methodology
19 that the company uses for setting retail rates, with differences in the values used for
20 certain inputs, including fill factors, cost of capital and depreciation rates.²⁶

21 Q. What is your response to these claims?

²¹ *Id.*

²² *Id.*

²³ Schedule JRS-5.

²⁴ Direct Testimony of James R. Smallwood, p. 4.

²⁵ *Id.*, pp. 4-5.

²⁶ Direct Testimony of Eric Panfil, p. 9.

1 A. Updates should not produce costs that indicate rates that are many times
2 the rates set by this Commission in the last UNE proceeding. Indeed, some
3 considerations would indicate cost reductions over the past years. For example, the
4 yield on 10–year treasuries has declined from 5.26 percent in 1998, which the last UNE
5 order was issued, to 4.01 percent in February 2003.²⁷ Similarly, over the same period
6 corporate Aaa bond (Moody's) yields declined from 6.53 percent to 6.09 percent.²⁸
7 Since capital costs are a significant part of the costs of providing UNEs, such declines in
8 the “cost of money” should contribute to lesser costs for UNEs, not much greater UNE
9 costs as SBC Illinois claims. I address the company's cost models and inputs
10 subsequently in this testimony.

11 **V. Cost Models**

12 Q. Is the company's approach yielding forward–looking costs, as the
13 company claims?

14 A. No. The company is not accurately reflecting labor productivity gains that
15 should be anticipated in the future.

16 Q. Why?

17 A. SBC Illinois witness David J. Barch states that the company's studies
18 apply two types of inflation factors to develop costs for the study period — one for
19 investments and the second for expenses.²⁹ This is change from the last UNE case,
20 when inflation was represented through the maintenance factor applied to plant
21 investments.³⁰ In the current case, the inflation factors applied to investments are
22 based on the Telephone Plant Index (“TPI”), while the inflation factors applied to

²⁷ Economic Indicators January 2003, Prepared for the Joint Economic Committee by the
 Council of Economic Advisors, Interest Rates and Bond Yields, p. 30.

²⁸ *Id.*

²⁹ Direct Testimony of David J. Barch, pp. 48–49.

³⁰ Schedule JRS–1.

1 expenses are based on the Consumer Price Index ("CPI").³¹ According to witness
2 Barch, the TPI produces a reasonable estimate of the price changes and efficiencies for
3 plant accounts, and the CPI is a widely used price-change indicator for labor costs and
4 other expenses.³²

5 Q. Do you agree?

6 A. No. It is not correct to employ the CPI as an inflation factor as SBC Illinois
7 has done in its analyses. The company's approach probably results in a very significant
8 overstatement of the company's labor costs for UNEs in the study period.

9 Q. What CPIs does SBC Illinois use in its analyses?

10 A. According to data in the company's cost files, the company employed
11 forecast increases in the CPI in the range of 2.3 to 2.7 percent for 2001 and beyond.³³

12 Q. Is the CPI an indicator of wage costs?

13 A. No. The CPI is a measure of retail prices paid by wage earners, not the
14 wages these people receive. Over the longer haul, wages and retail prices may loosely
15 track each other for the overall economy. However, this relationship may not hold for
16 specific sectors of the economy, and it certainly does not hold for telecommunications.

17 Q. How do you know this?

18 A. The CPI has increased steadily. Cumulatively, it has increased very
19 significantly. If the price increase for telecom services had matched the CPI, prices that
20 consumers would have to pay for telecom services would be far greater than they
21 actually are today. As an illustration, with a CPI of 100 for a base period of 1982-84,
22 the index in 1958 was 28.9.³⁴ By 2002, the CPI had increased more than six-fold to

³¹ Direct Testimony of David J. Barch, p. 49.

³² *Id.*

³³ Illinois Cost Filing December 2002, Annual Cost Factors, Labor Rates, Shared & Common and Support Assets, CPI 2001.xls.

³⁴ U.S. Department of Labor, Bureau of Labor Statistics, U.S. City Average, Not Seasonally Adjusted, <www.bls.gov>

1 179.92.³⁵ Fortunately, telephone services are not six times as expensive today as in
2 1958, or anywhere near it. In fact, the costs of some telecommunications services,
3 such as higher mileage "long distance" calls, have declined in absolute terms.

4 Q. What is your conclusion from these relationships?

5 A. The telecommunications industry has enjoyed the benefits of significant
6 productivity improvements so that it has not been necessary to increase prices at a rate
7 even remotely approaching general inflation levels.

8 Q. Is there additional evidence that the telecommunications industry is unique
9 in terms of cost trends?

10 A. Yes. The Bureau of Labor Statistics publishes a separate CPI for
11 telephone services to consumers in urban areas. In February 1998, when the order in
12 last UNE case was released, this index for telephone services stood at 100.0.³⁶ Five
13 years later, in February 2003, the index was 100.5.³⁷ Basically, the inflation in
14 telephone prices was one-half of one percent in total over the five years. In contrast,
15 the index for all goods and services increased from 161.9 to 183.1 over the same five-
16 year period.³⁸ This is an increase of about 13 percent — fully 26 times the increase in
17 the index for telephone services.

18 Q. Has SBC Illinois recognized the lesser increases in the CPI for telecom?

19 A. No. As I noted above, the company is assuming that the CPI will increase
20 at a rate of more than 2.3 percent per year. Thus, not only is the company failing to
21 address productivity changes by using the CPI as a surrogate, it is using the wrong CPI
22 — an aggregate index rather than an index for the telecom sector.

³⁵ *Id.*

³⁶ U.S. Department of Labor, Bureau of Labor Statistics, U.S. City Average Telephone Services, Not Seasonally Adjusted, December 1997=100, <www.bls.gov>

³⁷ *Id.*

³⁸ U.S. Department of Labor, Bureau of Labor Statistics, U.S. City Average All Items, Not Seasonally Adjusted, December 1982-84=100, <www.bls.gov>

1 Q. Has this Commission recognized productivity gains for SBC Illinois in
2 orders concerning the company's retail services?

3 A. Yes. The Price Cap Index in the alternative regulatory plan previously
4 approved for SBC Illinois contained a term called the "Productivity Offset" or "X-factor"
5 which recognized productivity gains as an offset to the general inflation rate.³⁹ The
6 Productivity Offset was composed of three parts: (1) a productivity differential which
7 measures the difference between telecom total factor productivity gains and the
8 productivity gains for the overall economy; (2) an input price differential which measures
9 the difference between telecom input prices (the prices paid by the company for the
10 resources it must acquire to provide its own services) and economy-wide input prices;
11 and (3) a consumer dividend, which is a factor adopted by the Commission based upon
12 its expectations regarding technological and/or regulatory changes that the Commission
13 anticipates.⁴⁰ In 1994, the Commission set these components at 1.3 percent, 2.0
14 percent, and 1.0 percent, respectively, or a total of 4.3 percent for the duration of the
15 plan.⁴¹

16 Q. Has the Commission revisited the alternative regulation plan?

17 A. Yes. The Commission addressed this plan in Docket Nos. 98-0232 and
18 98-0335 (consolidated). It is my understanding that the Commission has not released a
19 final order in that proceeding, but the Hearing Examiners have issued a Proposed
20 Order. In that Proposed Order, the Hearing Examiners recommend continuing the X-
21 Factor at 4.3 percent, including the productivity differential, input price differential and
22 consumer dividend.⁴²

³⁹ Illinois Commerce Commission, Summary Explanation: Alternative Regulation Plan for Illinois Telecommunications Carriers.

⁴⁰ *Id.*, p. 3.

⁴¹ *Id.*

⁴² Docket Nos. 98-0252, 98-0335, and 00-0764 (consolidated), Hearing Examiners' Proposed Order, March 21, 2001, p. 92.

1 Q. What is your recommendation concerning the company's UNE charges in
2 this case?

3 A. I urge the Commission to adopt an offset to the inflation factors (TPI on
4 material and CPI on labor) in the company's cost projections. Specifically, I suggest
5 that the Commission employ an offset of at least 4.3 percent.

6 **VI. Capital Structure**

7 Q. What is the next issue concerning the company's costing process that you
8 will discuss?

9 A. I will address capital structure, which refers to the proportions of debt and
10 equity employed to determine the overall cost of capital.

11 Q. How does capital structure enter into the costing process?

12 A. The return requirements for equity are higher than those for debt, so that a
13 greater equity component increases the overall cost of capital. Moreover, a greater
14 equity component results in a greater allowance for income taxes since equity income is
15 taxable, while interest expense is tax deductible.

16 Q. Is capital structure important in determining the charges for UNEs?

17 A. Yes. A capital structure that leads to inflated costs causes higher
18 proposed charges for all UNEs using the company's facilities and equipment.

19 Q. What capital structure does SBC Illinois ask the Commission to adopt in
20 this case?

21 A. SBC Illinois witness William E. Avera recommends a capital structure of
22 14 percent debt and 86 percent equity as a basis for the company's assumed weighted
23 average cost of capital.⁴³

24 Q. How does witness Avera arrive at this capital mix?

⁴³ Direct Testimony of William E. Avera, December 23, 2002, p. 7.

1 A. He indicates that the source of this mix is data for a "group of LECs
2 followed by Standard & Poor's Corporation."⁴⁴

3 Q. Should a capital structure with about 14 percent debt and 86 percent
4 equity be employed in setting the company's UNE charges?

5 A. No.

6 Q. What is the appropriate forward-looking capital structure in this case?

7 A. The Commission should adopt a capital structure of 35 percent debt as
8 the minimum. That structure conservatively represents the company's regulated
9 operations over the study planning period, which the company defines as "2002 through
10 2005" inclusive.⁴⁵

11 Q. What justification does SBC Illinois witness Avera offer for his very low
12 debt ratio?

13 A. He acknowledges that his "market value-based" capital structure is very
14 different from the actual capital structure reflected by the financial data on the
15 company's books.⁴⁶ However, witness Avera states that since this proceeding is
16 concerned with the costs and charges for UNEs in future years, it is important to employ
17 a "forward-looking" structure rather than the capital mix actually employed and reflected
18 in the company's books and accounts.⁴⁷

19 Q. Does SBC Illinois have an exact target capital structure?

20 A. The company responded to a data request by the Staff that it did not have
21 an exact target.⁴⁸ In that response, SBC claims that it "manages" its capital structure "in

⁴⁴ *Id.*, p. 6.

⁴⁵ Direct Testimony of David J. Barch, p. 39.

⁴⁶ Direct Testimony of William E. Avera, December 23, 2002, pp. 30-32.

⁴⁷ *Id.*

⁴⁸ SBC Illinois Response to Staff Data Request No. TM 9.

1 a conservative manner consistent with its desire to maintain the highest credit rating in
2 the telecommunications industry.”⁴⁹

3 Q. Is that the optimum policy?

4 A. No. From my perspective, the goal should be to minimize costs, not to
5 maintain the highest credit rating in the industry. To a point, a good credit rating helps
6 to reduce costs because the company can borrow for less. However, beyond some
7 point there is a net increase in the cost of a low-debt or no-debt strategy.

8 Q. Should a “forward-looking capital structure” with 16 percent debt and 84
9 percent equity be used to set UNE charges?

10 A. No. A capital structure of 16 percent debt and 84 percent equity is not a
11 reasonable forward-looking target. Indeed, if it is a “target” at all, it is so far in the future
12 as to be irrelevant in setting rates in this proceeding.

13 Q. Should the capital structure for this proceeding reflect “market values”
14 rather than book costs, as the company's witness claims?

15 A. No. It is important to reflect the values that can be anticipated over the
16 period when the rates at issue are in effect.

17 Q. Did SBC Illinois previously propose a hypothetical capital structure as the
18 basis for wholesale rates in Illinois?

19 A. Yes. In the last UNE case, the company proposed a capital structure with
20 25.4 percent debt and 74.7 percent equity.

21 Q. Did the Commission adopt that proposal?

22 A. No. The Commission rejected the proposal and adopted a capital
23 structure reflecting a mix of short-term debt, long-term debt, and equity.⁵⁰ Moreover, I
24 note that the Commission specifically cautioned against using the capital structure for a

⁴⁹ *Id.*

⁵⁰ ICC Docket No. 96-0486/0539, Second Interim Order, February 17, 1998, pp. 10-12.

1 "sample group" of other companies as a means for determining the structure for SBC
2 Illinois.⁵¹ As I indicated above, this is the same approach that SBC Illinois witness
3 Avera uses in this case.

4 Q. What is the company's current capital structure?

5 A. According to SBC's Annual Report, the capital structure for the company's
6 operations on a consolidated basis was 39.9 percent debt at year-end 2002.⁵²

7 Q. Has the capital structure changed over time?

8 A. Yes, but very gradually. For example, the debt ratio was 42.9 percent at
9 the end of 1999.⁵³ This ratio increased to 45.0 percent for 2000, and then declined
10 slightly to 44.3 percent in 2001.⁵⁴

11 Q. Are there steps that SBC Illinois could take to bring its capital structure in
12 line with the 16 percent debt – 84 percent equity mix that witness Avera advocates?

13 A. Theoretically yes, but for an organization of the company's size, significant
14 shifts in the capital structure would take a long time to accomplish. To shift its capital
15 structure this much, SBC Illinois would have to retire many billions of dollars of debt
16 and/or issue many billions of dollars of equity capital. As a practical matter, this could
17 not be done within the study planning period.

18 Q. In summary, why do you recommend that the Commission employ a
19 capital structure of at least 35 percent debt in this case?

20 A. A debt ratio of 35 percent is less than the 40 percent debt ratio shown on
21 the company's books for the end of last year. On the other hand, the company's
22 "market value-based" concept is a fictional target that is inappropriate in this case
23 because of the company's significant market power. As I noted above, this market

⁵¹ *Id.*, p. 12.

⁵² SBC Communications Inc. Annual Report 2002, p. 4.

⁵³ *Id.*

⁵⁴ *Id.*

1 power is demonstrated by the fact that SBC Illinois serves the great majority of retail
2 customers within its operating area, and the fact that SBC Illinois is the only carrier that
3 can provide UNEs for access to its extensive local wireline network.

4 Q. You stated that in the last case, the Commission accepted a three-part
5 capital structure — with weights for short-term debt, long-term debt and equity — in
6 determining cost of capital for UNEs. What would be the corresponding mix at this
7 time?

8 A. According to the response by SBC Illinois to a data request by AT&T
9 Communications, the capital structure on December 31, 2002 was 25.4 percent short-
10 term debt, 13.1 percent long-term debt, and 61.5 percent equity.⁵⁵ I have no objection
11 to this mix for setting the UNE charges if the Commission decides to use a three-part
12 structure again.

13 VII. Fill Factors

14 Q. What issue will you address next?

15 A. I will address the utilization of the company's outside plant. The utilization
16 or "fill factor" for a facility is the proportion used to provide services. The assumed fill
17 has a significant impact because all costs, including those of "unused" facilities, are
18 allocated over the revenue-producing units of service to determine the total costs, and
19 hence the proposed charges for UNEs.

20 Q. What fill factors does SBC Illinois use for computing costs associated with
21 UNEs?

22 A. SBC Illinois witness Smallwood states that the UNE costs developed for
23 this proceeding use the company's present fill factors as projections of the expected fills
24 for low capacity local loops (e.g. 2-wire and 4-wire loops).⁵⁶ For high capacity loops

⁵⁵ SBC Illinois Response to AT&T Communications, Inc. Data Request No. TM 1.

⁵⁶ Direct Testimony of James R. Smallwood, p. 9.

1 (e.g. DS-1 and DS-3) projected fills are determined on the basis of estimates by
2 subject matter experts.⁵⁷

3 Q. Do you object to this methodology?

4 A. I do not object to the use of subject matter experts if these individuals are
5 fairly weighing all of the evidence and making reasoned projections for the future, but it
6 is not adequate to simply assume that the future will look like the present.

7 Q. Has the FCC addressed the use of fill factors in UNE cost studies?

8 A. Yes. As SBC Illinois witness Smallwood notes, the FCC requires that fills
9 reflect a "reasonable projection of the actual total usage of the element."⁵⁸ The witness
10 asserts that the company has complied with this directive because current fill levels are
11 the best projection of actual fills in the future.⁵⁹

12 Q. Do you agree?

13 A. No.

14 Q. Why?

15 A. Current fills may be lower than anticipated over the longer run, because
16 the company has been accelerating additions to outside plant, possibly in response to
17 service quality concerns. The Proposed Order by the Hearing Examiners in Docket
18 Nos. 98-0232 and 98-0335 (consolidated) that I mentioned above addresses service
19 quality issues. The order refers to the company's "service quality failures" and notes
20 that the company has acknowledged some degradation in service quality.⁶⁰

21 Q. What would be a logical response to admonitions concerning reduced
22 service quality levels?

⁵⁷ *Id.*, p. 10.

⁵⁸ *Id.*, p. 7, citing Federal Communications Commission, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, para. 682.

⁵⁹ Direct Testimony of James R. Smallwood, p. 10.

⁶⁰ Docket Nos. 98-0252, 98-0335, and 00-0764 (consolidated), Hearing Examiners' Proposed Order, March 21, 2001, p. 131 and p. 135.

1 A. One logical response would be to accelerate additions to outside plant.
2 As a consequence, the current fills would decline, and then increase in the future.
3 Thus, the "current" values" that SBC Illinois is using are not necessarily representative
4 of the conditions to be observed over the study period.

5 Q. Do you have any indication of unusually large additions to outside plant
6 accounts in the past few years?

7 A. Yes. The following table shows beginning year balances and plant
8 additions for aerial cable as reflected in reports for the FCC's Automated Reporting
9 Management Information System ("ARMIS") covering Illinois for the last few years.⁶¹

	<u>Beginning Year</u> <u>Balance</u> (000)	<u>Plant</u> <u>Additions</u> (000)	<u>Percentage</u>
1998	\$ 575,254	\$ 31,317	5.44 %
1999	\$ 596,741	\$ 31,730	5.32 %
2000	\$ 620,473	\$ 28,609	4.61 %
2001	\$ 642,377	\$ 65,492	10.20 %
2002	\$ 699,067	\$ 49,322	7.06 %

18 In the last two years, aerial cable plant additions have increased significantly as a
19 percentage of the plant balance at the beginning of the year.

20 Q. Are there additional reasons why fills should increase?

21 A. Yes. With more carrier participants in the market — *i.e.*, competitive
22 LECs who will acquire UNEs if the price is reasonable — there will be opportunities for
23 SBC Illinois to obtain additional revenue and use cable plant more efficiently by
24 increasing average fill levels. Also, planning efforts should become more sophisticated
25 and accurate. This should enable SBC Illinois to improve on past performance.

⁶¹ Federal Communications Commission, SBC ARMIS Report 43-02, Table B1b.

Moreover, by setting fill levels for cost recovery higher than recent experience, the Commission can give SBC Illinois the incentive to do just that.

Q. Did the Commission address this issue in the last UNE case?

A. Yes. The Commission adopted a set of target fill factors that its Staff proposed.⁶² The target fills were 85 percent for copper feeder and 33 percent for fiber feeder.⁶³ The target for distribution plant was 80 percent.⁶⁴ Thus, the use of current fills, as SBC Illinois is proposing in this case, is another departure from the approach that the company previously employed to estimate UNE costs.⁶⁵

Q. What are the current fills that SBC Illinois proposes to use as targets in this case?

A. The alleged "current" fills are shown in the following table:⁶⁶

	<u>Copper Feeder</u>	<u>Distribution</u>
Zone A	**-----**	**-----**
Zone B	**-----**	**-----**
Zone C	**-----**	**-----**

Q. Do you have a comments on these distribution fills?

A. Yes. The "actual" distribution fills, **-----
-----** In
response to a data request by the Staff, the company states that its network planning dictates that when cable is placed in many residential areas, the cable is sized to meet the needs of two pairs per lot plus one maintenance spare for every four units, which

⁶² ICC Docket No. 96-0486/0539, Second Interim Order, February 17, 1998, p. 34.

⁶³ Staff Data Request No. HBG 2.03.

⁶⁴ *Id.*

⁶⁵ Schedule JRS-1.

⁶⁶ ILCurrentFillData2002 (Jan02).xls.

1 equates to 2.25 pairs per living unit.⁶⁷ Then, in response to a data request by AT&T, **-

6 -----⁶⁸ **

7 Q. What is your recommendation?

8 A. I believe it is important to balance a number of factors. First, there are a
9 number of definitional issues concerning the target fills that the Commission prescribed
10 in the last UNE case, as discussed in the testimony of SBC Illinois witness Smallwood.⁶⁹
11 On the other hand, the sharp reduction in fills by using the current "actual" values will
12 have a major and potential disruptive effect on UNE costs. Moreover, **-----
13 -----** Balancing these considerations, I
14 recommend using a target fill of 70 percent for all cooper feeder and a target fill of 45
15 percent for the distribution plant. These figures "back down" considerably from those
16 previously employed, but still provide some "stretch" from the values that SBC Illinois
17 proposes.

18 VIII. Avoided Advertising Costs

19 Q. Do you address additional issues that lead to inflated prices for UNEs?

20 A. Yes. I address the costs that SBC Illinois avoids in providing services to
21 competitive LECs on a wholesale basis. As discussed in the testimony of SBC Illinois
22 witness David J. Barch, the company's claimed UNE costs reflect a wholesale shared

⁶⁷ SBC Illinois Response to Staff Data Request No. PL 1.04.

⁶⁸ SBC Illinois Response to AT&T Data Request No. RFP-492.

⁶⁹ Direct Testimony of James R. Smallwood, p. 9 *et seq.*; and SBC Response to Staff Data Request No. HBG 2.03.

1 and common ("S&C") cost factor.⁷⁰ The procedure SBC Illinois uses to determine this
2 factor overstates the costs of UNEs because it fails to account for costs that are avoided
3 in providing services to other carriers on a wholesale basis.

4 Q. What cost savings does SBC Illinois fail to consider?

5 A. The cost factor reflects "wholesale marketing costs" which include costs in
6 Account 6613, Product Advertising.⁷¹ According to SBC Illinois, this account includes
7 "the costs of developing and implementing promotional strategies to stimulate the
8 purchase of products and services."⁷² The company also states that "this includes non-
9 product-related advertising, such as corporate image, stock and bond issue and
10 employment advertisements, which should be included in the appropriate functional
11 accounts."⁷³

12 Q. Should such product-related costs be reflected in the charges for UNEs?

13 A. No.

14 Q. Why?

15 A. Advertising is unnecessary for the facilities and services at issue in this
16 proceeding because carriers acquiring UNEs are well aware of the only source of supply
17 — the incumbent LEC. SBC lists a number of "advertising campaigns" or "products"
18 with costs in the account.⁷⁴ The list includes "products" such as "Winback" for which
19 advertising would not seem to provide any benefit whatsoever for carriers needing
20 UNEs. It is true that the list includes some "products" such as "Access Lines" that other
21 carriers acquire as UNEs, but SBC Illinois' advertising of access lines should be
22 directed at end users who would acquire these facilities directly from the company.

⁷⁰ Direct Testimony of David J. Barch, pp. 4–9 *et seq.*

⁷¹ Shared & Common Cost Study – Illinois, Tab 1, lines 26–28 and Tab 3, Lines 142–146, Column L.

⁷² SBC Illinois Response to Staff Data Request No. PL 1.32a.

⁷³ *Id.*

⁷⁴ SBC Illinois Response to Staff Data Request No. PL1.32c.

1 Other carriers acquiring facilities on a wholesale basis do not need to be informed
2 through advertising that access facilities are available from the incumbent LEC.

3 Q. Did the Commission previously address advertising costs for wholesale
4 services?

5 A. Yes. The Commission found advertising costs are an appropriate
6 component of wholesale costs in its order setting the "discount" for resold services. In
7 that order, the Commission found that it is reasonable for the company to advertise for
8 the purpose of "informing resellers of available services."⁷⁵ However, in my view, even
9 if advertising is necessary to inform resellers, it is not necessary to inform carriers
10 needing UNEs because there is a defined and rather static list of such elements.

11 Q. Who should bear the costs of advertising?

12 A. Advertising to promote demand by the ultimate users — the competitors'
13 customers — should be the responsibility of the competitive LECs themselves. Indeed,
14 competitors must advertise their own services. On the other hand, it is virtually certain
15 (and understandable) that SBC Illinois would aim any advertising in order to promote
16 use of the company's own services, rather than to promote the activities of its
17 competitors. Thus, by including advertising costs in its charges to carriers acquiring
18 UNEs, SBC Illinois is asking its competitors to pay for activities designed to thwart their
19 own interests.

20 Q. In your view, does SBC Illinois acknowledge that there is no advertising
21 associated with UNEs?

22 A. Yes. The Staff propounded a data request asking the company to "identify
23 specific campaigns being conducted to foster, facilitate or otherwise enhance or
24 improve the sale of [its] UNE services."⁷⁶ The company responded, "There are currently

⁷⁵ AT&T Communications of Illinois, Inc. Petition for a total local exchange wholesale tariff from Illinois Bell Telephone Company, Docket Nos. 95-0458 and 95-0531 (consolidated), Order, June 26, 1996, p. 32.

⁷⁶ Staff Data Request No. TQS 4.06.

1 no existing campaigns being conducted."⁷⁷ In my view, this response provides no basis
2 for including advertising expenses in the UNE costs.

3 Q. According to SBC, Account 6613 also includes the costs of advertising of
4 a broader corporate nature, such as stock and bond issues and efforts to recruit
5 employees, in spite of the fact that the account is titled "Product Advertising". Are the
6 costs of some of these "broader" advertising activities appropriately ascribed to UNEs?

7 A. Perhaps some of the costs could be associated loosely with UNEs. For
8 example, new employees recruited through advertising could work on SBC's activities
9 concerning UNEs as well as activities concerning provision of services directly to end
10 users. Apparently, however, there is no data available to break down the costs in
11 Account 6613 into its various components. Indeed, SBC responded to a data request
12 by the Staff seeking a breakdown of the activities associated with Product Advertising
13 by reference to its previous response with the description of the costs contained in the
14 account.⁷⁸

15 Q. In view of the conclusions you have discussed above, what is your
16 recommendation concerning advertising costs?

17 A. I urge the Commission to require SBC Illinois to remove all advertising
18 expenses assigned to UNEs in its studies.

19 **IX. Additional Costs of Unbundled Local Loops**

20 Q. Are there additional issues concerning the company's estimates of the
21 costs of unbundled local loops?

22 A. Yes. Schedule JRS-1, which compares the company's present
23 methodology with that in the previous UNE case, indicates that a number of premise

⁷⁷ SBC Illinois Response to Staff Data Request No. TQS 4.06.

⁷⁸ SBC Illinois Response to Staff Data Request No. PL 1.32b, citing Response to Staff Data Request No. 1.32a.

1 termination cost elements which are included with loop costs in the present case were
2 not included with loop costs in the previous case. These are network interface devices
3 ("NIDs"), building terminals, and building entrance facilities.

4 Q. Do you object to these changes?

5 A. Not necessarily, but the changes raise two issues. First, such "rebundling"
6 reduces flexibility. If competitive LECs do not need the termination elements, or have
7 different ways to provision this capability, bundling forces competitors to pay for
8 redundant capability. Second, if SBC Illinois had separate charges for these termination
9 elements, they should desist if the new approach is adopted because they are being
10 recovered through loop charges by the company's admission.

11 Q. Does Schedule JRS-1 raise other issues concerning additional costs?

12 A. Yes. I note a significant increase from 67.32 percent to 76.68 percent in
13 the "conduit factor" used to reflect the costs of conduit in the costs of unbundled local
14 loops.⁷⁹

15 Q. How is the conduit factor computed?

16 A. According to the company's Cost Tool Documentation, the conduit factor
17 is based on the ratio of investment in conduit construction to underground cable
18 construction over the previous three-year period.⁸⁰

19 Q. Is this a reasonable approach?

20 A. Theoretically yes, but because of a discontinuity in the data, the
21 company's approach leads to an increase in the conduit cost which is probably not
22 representative of the future. The company's ARMIS Reports shows the following
23 additions for Illinois conduit and underground cable for the three years concluded prior
24 to October 2002.

⁷⁹ Schedule JRS-1.

⁸⁰ Loop Cost Analysis Tool (LoopCAT) Cost Tool Documentation, Schedule JRS-3 of the Direct Testimony of James R. Smallwood, p. 22.

		<u>Conduit Additions</u> (000)	<u>Underground Cable Additions</u> (000)	<u>Percentage</u>
1				
2				
3				
4				
5	1999	\$ 28,201	\$ 42,504	66.35%
6	2000	\$ 34,881	\$ 55,609	62.73%
7	2001	\$ 67,686	\$ 72,860	92.90%

8 By my calculation, the weighted average for the three years is 76.48 percent, which
9 agrees closely with the 76.68 percent shown on Schedule JRS-1. However, this factor
10 is heavily influenced to the sharp increase in conduit additions in 2001.

11 Q. What is your recommendation?

12 A. I urge the Commission to require SBC Illinois to demonstrate that the
13 conduit factor that it employs in this case is the best possible representation of
14 conditions over the study period 2002 through 2005.

15 **X. Wholesale Shared and Common Cost Factor**

16 Q. What is the final issue that you will discuss in this testimony?

17 A. I shall discuss the structure of the company's wholesale S&C cost factor,
18 which purportedly accounts for costs that are ascribed to UNEs but not included in the
19 TELRICs that are computed for the respective elements. The wholesale S&C cost
20 factor, **-----**, is applied to each of the TELRICs to determine the recurring
21 charge that the company proposes.⁸¹ The development of the company's wholesale
22 S&C cost factor is described in the Direct Testimony of SBC Illinois witness David J.
23 Barch.⁸²

24 Q. How is the wholesale S&C cost factor determined?

⁸¹ Schedule MDS-2 to Direct Testimony of Michael D. Silver.

⁸² Direct Testimony of David J. Barch, pp. 5-31.

1 A. The procedure is complex, but there are basically two terms — a common
2 cost factor and a shared cost factor. In summary, the formula is:

3 (TOTAL COMMON COSTS / TOTAL DIRECT COSTS)

4 +

5 (WHOLESALE SHARED COSTS / WHOLESALE DIRECT COSTS)

6 The procedures for determining the parts of this formula are described in Tabs 1, 2 and
7 3 of the Shared & Common Cost Study on the CD for the December 2002 Cost Filing
8 containing Annual Cost Factors, Labor Rates, and Shared & Common and Support
9 Assets.

10 Q. In summary, what is your assessment of the company's methodology?

11 A. The procedure that SBC Illinois employs to determine the S&C cost factor
12 has many structural problems, so it not useful as a means of estimating the magnitude
13 of the shared and common costs that should be reflected in UNE charges.

14 Q. Would you identify some of these problems?

15 A. Yes. At the outset, the denominator for the factor contains a major
16 inconsistency in that Total Plant in Service is added to Total Operating Expenses.⁸³
17 Investment costs and expenses have different temporal dimensions. The first is an
18 asset and liability (or balance sheet) concept, which is a picture at one point in time.
19 The second is an income and expense concept, which is a representation for a span of
20 time such as a year. Because they have different dimensions, plant investment and
21 expenses should not be added together. Moreover, there is an additional problem in
22 adding Total Plant in Service to Total Operating Expenses in that the later include
23 depreciation expenses. Since depreciation derives from plant balances, there is a
24 circularity involved in the combination of these elements.

25 Q. Are there additional problems with the company's S&C cost study?

⁸³ S&C Cost Study, Tab 1, lines 18 and 19.

1 A. Yes. There is a also a problem with adding two quantities with different
2 temporal dimensions in the numerator of common cost factor. Executive and Planning
3 Expenses, as well as General and Administrative Expenses, such as Accounting and
4 Finance, are added to Support Costs, which is a part of Total Plant in Service – General
5 Support.⁸⁴ Again, balance sheet items are added to items that would appear on an
6 income and expense statement.

7 Q. Are there also problems with the second term of the formula, the Shared
8 Cost Factor?

9 A. Yes. There are also problems with this factor, **-----
10 -----** . The company's Shared Cost Factor is
11 the ratio of wholesale shared marketing and uncollectibles to total wholesale direct
12 costs.⁸⁵ In the first place, advertising costs should not be reflected in UNE charges, as I
13 explained above. However, there is an additional problem in that the company applies
14 this cost factor not simply to marketing costs but to the total recurring cost for the
15 element determined through the TELRIC process. The TELRICs include annualized
16 representations of all direct costs, including for example, maintenance, depreciation,
17 return, debt service and income taxes. There is no congruity of scope between the
18 quantities used to determine the Shared Cost Factor and the base to which this factor is
19 applied. Moreover, the denominator of the Shared Cost Factor is also derived basically
20 from the same "sum" of Total Plant in Service and Total Operating Expenses which has
21 the dimensional inconsistency that I discussed above.⁸⁶

22 Q. What is your recommendation?

23 A. There are various ways to reflect shared and common costs, but at least
24 now, I would recommend a simpler approach using a single ratio.

⁸⁴ *Id.*, lines 1 to 10, and line 11.

⁸⁵ *Id.*, line 40.

⁸⁶ *Id.*, line 35 compared with line 22.

1 Q. What would be included in the numerator of the ratio?

2 A. The numerator would include Marketing Expenses associated with UNEs,
3 Services Expenses associated with UNEs, Executive and Planning Expenses, General
4 and Administrative Expenses, and an expense representing an allowance for
5 Uncollectible Revenues. The Marketing Expenses (equivalent to line 146 on Tab 3)
6 would exclude Product Advertising costs as well as Product Management and Sales
7 expenses solely related to retail products and retail sales activities. Executive and
8 Planning Expenses (equivalent to line 159 on Tab 3) and General and Administrative
9 Expenses (equivalent to line 170 on Tab 3) could be included.

10 Q. What would be included in the denominator of the ratio?

11 A. The denominator should be total expenses. That is, the denominator
12 should include the shared and common expenses in the numerator, as well as the direct
13 expenses. The Direct Expenses include Plant Specific Operations Expenses
14 (equivalent to line 115 on Tab 3) and Plant Nonspecific Operations Expenses
15 (equivalent to line 140 on Tab 3). In addition, the Direct Expenses in the denominator
16 should include interest, equity return and income taxes (*i.e.* the "cost of money" and
17 income taxes).

18 Q. Why should the "cost of money" and income taxes be included in the
19 denominator of the ratio used to develop the S&C Cost Factor?

20 A. The S&C cost factor is multiplied by TELRICs to produce the total cost to
21 be covered by UNE charges. Therefore, the S&C cost factor and the TELRICs should
22 be comparable in scope. The TELRICs include the cost of money and income taxes.⁸⁷
23 If these quantities are not included in the denominator of the S&C cost factor, the
24 resulting product will overstate the cost appropriately recovered through the process.

⁸⁷ Schedule DJB-2.

1 Q. Have you developed an S&C Cost Factor to replace the **-----**
2 proposed by the company?

3 A. I do not have the data to develop the factor precisely, but I believe it is
4 possible to determine a maximum, or upper bound, using booked costs for Illinois as of
5 December 31, 2001 shown in the company's S&C Cost Study.

6 Q. Please continue.

7 A. The Illinois Marketing Expenses, Services Expenses, Executive and
8 Planning Expenses, and General and Administrative Expenses total \$759 million.⁸⁸ The
9 company shows Uncollectible Revenues of \$116 million.⁸⁹ To get an upper bound, I
10 would include all of these expenses (\$875 million) as the numerator of the S&C Cost
11 Factor ratio, without excluding advertising or customer services functions that have no
12 connection with UNEs. Turning to the denominator, Illinois Plant Specific Operations
13 Expenses and Plant Nonspecific Operations Expenses total \$1,985 million.⁹⁰ Total
14 Plant in Service is \$12,070 million.⁹¹ From the company's ARMIS Report, the
15 corresponding Net Total Property and Equipment is \$5,704,000 million. The company's
16 return requirements for UNEs are a contested issue in this case, but for purposes of
17 estimating an S&C cost factor, I shall conservatively assume a pre-tax return factor of
18 14 percent. Thus, the net plant of \$5,704,000 is multiplied by 0.14 to get an allowance
19 of \$800 million for cost of money and income taxes.

20 Q. What is the net result?

21 A. As an upper bound, the numerator of the S&C Cost factor would be \$875
22 million. The denominator would be \$875 million, plus \$1,985 million, plus \$800 million,
23 or a total of \$3,660 million. Therefore, an upper bound for the S&C Cost Factor would

⁸⁸ Tab 3, sum of lines 154 and 174, Column D.

⁸⁹ Tab 3, line 181, Column L.

⁹⁰ Tab 3, sum of lines 115 and 140, Column D.

⁹¹ Tab 3, line 65, Column D.

1 be the range of 24 percent, **-----
2 -----**. I do not believe that the S&C Cost Factor should exceed 24
3 percent, and it is likely that as additional evidence is adduced throughout the case, a
4 even lesser value would be indicated. Most importantly, I urge the Commission to
5 require that the company's UNE rates reflect an S&C Cost Factor that is developed
6 using internally consistent procedures, such as I have outlined above.

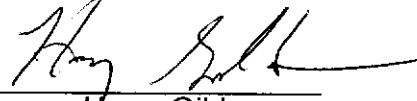
7 Q. Does that conclude your testimony?

8 A. Yes, it does.

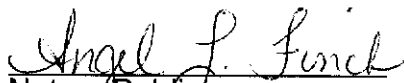
AFFIDAVIT OF HARRY GILDEA

DISTRICT OF COLUMBIA) SS:

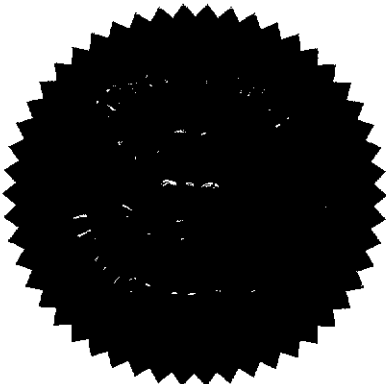
Before me, the undersigned Notary Public in and for the District of Columbia, this day personally appeared Harry Gildea, of Snavely King Majoros O'Connor and Lee, known personally to me, who stated under oath that the foregoing testimony, entitled Direct Testimony of Harry Gildea, in Illinois Commerce Commission Docket No. 02-0864, dated May 6, 2003, was prepared by him or under his direct supervision and control; that he has knowledge of the matters set forth in said testimony; and that such matters are true and correct to the best of his knowledge, information and belief.


Harry Gildea

Sworn before me this 2nd day of April, 2003


Notary Public

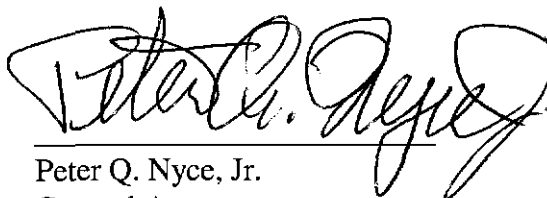
My commission expires March 14, 2006.



CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the Public Version of the Direct Testimony of Harry Gildea on behalf the United States Department of Defense and All Other Federal Executive Agencies was sent, by UPS or by first-class U.S. mail, to all parties on the attached service list. Further a copy of the Confidential Version was sent to those individuals on the attached service list who were also listed by the Company as Signers of Proprietary Agreement, Docket 02-0864.

Dated this 5th day of May 2003, at Arlington County, Virginia.

A handwritten signature in black ink, appearing to read "Peter Q. Nyce, Jr.", written over a horizontal line.

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